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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1945

No. 93

HERCULES GASOLINE COMPANY, INC.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR REHEARING

MELVIN F. JOHNSON,
Counsel for Petitioner.

JOSEPH H. JACKSON,
Of Counsel for Petitioner.

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COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR REHEARING

To the Honorable Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

Comes now Hercules Gasoline Company, Inc., petitioner in the above entitled cause, and presents this, its petition, for a rehearing in the above entitled cause and, in support thereof, respectfully shows:

I

The Court erred in its decision and judgment rendered December 17, 1945, in holding that the taxpayer, although bound not to distribute earnings, was not bound by the kind of contract the Court thought necessary.

The law plainly says corporations shall be given credit for a written contract which prohibits dividends.[1] Congress

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[1] The history of this legislation shows that the bill as introduced in the House contained Sec. XX which gave credit when the corporation "has made a bona fide contract not to pay dividends *or* not to pay out as dividends a stipulated portion of its earnings and profits for the taxable

did not confine the contracts to those made with creditors. In effect, the Court is writing this requirement into the statute. The Court is entering the legislative field. Supplying this omission transcends the judicial function of this Court. The Court has established landmarks directly to the contrary.[2] When a law is free and clear of ambiguity, the letter of the law should not be disregarded under the pretext of pursuing its spirit!

In this connection, the majority opinion states that we contended that your construction of Sec. 26(c)(1) was erroneous in the *Northwest Steel* case. This is error. We have never made this contention. We *have* contended as forcefully as we know how that the *Northwest Steel* case was not apposite to our case and that the Fifth Circuit erred in basing its decision on it. Furthermore, we stated to Mr. Justice Black in oral argument that we thought the Northwest Steel decision was correct on the facts of that case and under the law as it stood at that time.

II

The Court erred in finding support for construing Sec. 26 (c) (1) as confined to creditor-debtor contracts by a consideration of Sec. 26 (c) (3).

Many small corporations, like this taxpayer in 1933, in the late depression period were effectively prevented from

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year." See Rev. Act, 1936. Hearings before Ways and Means Committee, House of Representatives, p. 10 and 62.

The Commissioner (Mr. Helvering) stated the purposes of the legislation (Same, p. 19-20-22) and disclaimed any intention to interfere with the internal management of business enterprises.

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[2] *Iselin* vs. *U. S.*, 270 U. S. 245, 250, 251; 70 L. Ed. 569.

Sabine Tr. Co. vs. *Com.*, 318 U. S. 306; 87 L. Ed. 776.

Helvering vs. *Credit Alliance Corp.*, 316 U. S. 112; 86 L. Ed. 1312, holding with reference to the same law: "But whatever may be said of the policy behind the statute's provisions, we are not at liberty to disregard the direct and unambiguous language of subsection (f)."

distributing dividends by agreements with investors, preferred stockholders, banks and furnishers of material. It is a customary way to get small companies started. Section (3) merely states that if *both* paragraphs (1) and (2) apply, *the one of such paragraphs which allows the greater credit* shall be applied and if the credit under each paragraph is the same, *only one shall be applied.* The language "if the credit *allowable under each paragraph* is the same" impels the inference that at least two kinds of contract credit are included.[3] Thus the statute necessarily brings within its provisions instances of restrictions against dividends by contracts with investors as well as similar prohibitions by contracts with creditors. If there were two contracts and thus *both* credits were applicable, the larger should be applied. Either "kind" of contract would make the corporation unable to distribute earnings. The unavoidable implication is that more than one *"kind" of contract* is intended because Sec. 26(c)(3) brings about a comparison of and a separation between the two kinds and credit is ordered to *one or the other,* whichever is greater. Subdivisions (1) and (2) lay down the bases of credit and subdivision (3) measures one against the other to avoid duplication. Thus, the more reasonable result from a consideration of subsection (3), it seems to us, is directly contrary to the conclusion arrived at by the Court.

If Congress meant that only contracts with creditors should receive credit, *why did Congress write Sec. 26 (c) (1) into the enactment?* Why give this provision first place in the Section relating to credits?

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[3] This interpretation is further emphasized by the recurrence of the word "debt" four times in subsection (2) and its total absence in subsection (1). See Brief for Petitioner, p. 26-7.

III

The Court is wrong in its holding that the taxpayer's contract with its preferred stockholders was an intra-corporate agreement to keep profits in the corporation's treasury so that the tax collector could not reach them and then adding in the footnote (4) that petitioner might have redeemed the preferred stock issue in 1937.

In the very beginning of this controversy, the Commissioner only made the point that *the preferred stock certificates did not constitute a contract.* When the matter was tried in the Tax Court, petitioner's counsel approached proof of good faith and the corporation's inability to pay off the preferred stock in 1937, considering a large mortgage indebtedness and a lack of cash, whereupon counsel for the Government objected and stated that the issues did not include any question about the financial ability of the corporation to remove the restriction and pay dividends (R. 48-49). In the Tax Court, in the Fifth Circuit and in this Court, counsel for the Government have scrupulously stayed off this ground, conceding that the withholding of dividends was not wilful. In raising this question now, the Court should give us an opportunity to meet this new argument.

A holding that the stock certificate restriction here was intra-corporate was manifestly error because we have a situation where *outside persons were induced to purchase preferred stock* on the strength of *bona fide* representations that the common stockholders would receive no dividends until the preferred stock was retired (R. 67). These holders of preferred were a different set of stockholders! The intra-corporate theory falls when confronted with the facts in this case. This corporation was owned by its common stockholders. The corporation, on the one hand, contracted with its preferred stockholders (who had no vote

or notice of meetings), on the other hand, that the owners would get none of the profits until the preferred stockholders were paid off. The corporation had no real opportunity to keep its profits in the treasury, away from the tax collector. It was prevented by a series of binding contracts with outside people. *It had absolutely no choice to distribute profits to avoid the tax.*

The whole idea of the undistributed profits tax was not so much a tax as it was a penalty on those who deliberately chose not to distribute profits! It was aimed at accumulations of surplus. (See history above.) And this taxpayer, being bound by contract, had no choice in the matter. It was caught in a trap. The judgment of this Court that petitioner "was keeping profits in its treasury" is particularly severe.

IV

The Court erred, assuming for purposes of argument that Sec. 26 (c) (1) only covered contracts made with creditors, in not finding that this contract with preferred stockholders was a "routine contract dealing with ordinary debts."

When these parties bought preferred stock, they became creditors of the corporation. There was nothing extraordinary about this. The arrangement *was* a routine contract dealing with ordinary debts. The certificates were written contracts expressly dealing with the payment of corporate debts. The Record shows, as a matter of fact, that some of the persons who acquired the preferred stock were creditors and some were investors (R. 31-36; 67). After acquisition, they were all creditors who received a guaranteed return and who might be paid off any time on 30 days notice.

We sincerely believe Your Honor's decision is out of harmony with the great precedents established by this Court. We note that the case was decided ten days after

submission and by a divided Court. Since the issues involve rights vested in contract, a subject matter which was the concern of the framers of our Constitution, and being convinced that the Court will wish to review cases where there may be doubt as to the correctness of its decision, we humbly plead for a rehearing. We conceive it to be our duty to ask for a rehearing that this Court may avoid a bad precedent, where the Court amended a legislative enactment, where it disregarded principles established in the high jurisprudence of this Court and nation and where it has overlooked certain significant facts of the case under review.

Wherefore, upon the foregoing grounds, it is respectfully urged that the petition for a rehearing be granted and that the judgment of the Fifth Circuit be upon further consideration reversed.

Respectfully submitted,

MELVIN F. JOHNSON,
Counsel for Petitioner,
Hercules Gasoline Company, Inc.
JOSEPH H. JACKSON,
Of Counsel for Petitioner.

Certificate of Counsel

I, counsel for the above named Hercules Gasoline Company, Inc., do hereby certify that the foregoing petition for a rehearing of this cause is presented in good faith and not for delay.

MELVIN F. JOHNSON,
Counsel for Petitioner,
Hercules Gasoline Company, Inc.

SUPREME COURT OF THE UNITED STATES.

No. 93.—October Term, 1945.

Hercules Gasoline Company, Inc., Petitioner, *vs.* Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

[December 17, 1945.]

Mr. Justice Black delivered the opinion of the Court.

This case requires us to construe § 26(c)[1] of the undistributed profits tax law, 49 Stat. 1648, enacted by Congress in 1936. The undistributed profits tax, which was not continued by Congress after 1938, was a surtax at graduated rates upon corporate profits not distributed during the tax year by way of dividends. Section 26(c) allowed credits designed to afford relief where the payment of divi-

[1] "Sec. 26. Credits of Corporations:

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

. . . .

(c) Contracts Restricting Payment of Dividends.—

(1) Prohibition on payment of dividends.—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) Disposition of profits of taxable year.—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word 'debt' does not include a debt incurred after April 30, 1936.

(3) Double credit not allowed.—If both parargaph (1) and paragraph (2) apply, the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied."

dends is prevented by certain contract provisions. Subdivision (c)(1) of the section allowed such a credit where a distribution of earnings would violate a "*provision of a written contract executed by the corporation . . . which provision expressly deals with the payment of dividends.*" (Italics supplied). Subdivision (c)(2) allowed a credit where earnings and profits of the taxable year . . . [are] . . . required (*by a provision of a written contract executed by the corporation . . . which provision expressly deals* with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge *of a debt,* or to be irrevocably set aside within the taxable year for the discharge *of a debt.*" (Italics supplied). Petitioner claimed a credit under § 26(c)(1) but in assessing the deficiency for 1937 the Commissioner rejected this claim. The Tax Court sustained the Commissioner and its judgment was affirmed by the Circuit Court of Appeals. 147 F. 2d 972. We granted certiorari because of conflicting determinations by the Circuit Courts as to the scope of these credit provisions.[2]

Petitioner, a Delaware Corporation, admits liability as transferee of the assets of the Hercules Gasoline Company, Inc., a Louisiana Corporation, which was dissolved in 1939. Article V of the original charter of the transferor authorized the issuance of non-par common stock and of preferred stock at $50 par value. The preferred stock was entitled "to cumulative dividends at the rate of 8% per annum . . . in preference and priority to any payment of any dividend on the common stock for such year." The charter further provided that "there shall be no dividend on the common stock until all of the preferred stock has been retired, redeemed and discharged." All certificates of preferred stock contained the following provision: "For Rights and Voting Powers of Preferred Stock See Article V of Charter." The petitioner contends that these preferred stock certificates constituted contracts executed by the corporation which expressly prohibited the payment of dividends while these shares were outstanding and that petitioner is therefore entitled to the credit allowed under Subdivision (c)(1).

We think that the preferred stock certificates are not the kind of contracts which entitle a corporation to allowance of credit under Subdivision (c)(1). In our view that Subdivision must be read

[2] Lehigh Structural Steel Co. v. Commissioner, 127 F. 2d 67; Philadelphia Record Co. v. Commissioner, 145 F. 2d 612.

in the light of § 26(c) and the Act as a whole, and when thus read, is confined to contracts made with creditors and does not extend to restrictions imposed within the body corporate. In *Helvering* v. *Northwest Steel Mills,* 311 U. S. 46, the question before us was whether § 26(c)(1) allows a credit where the payment of dividends is prohibited by statute. In construing § 26(c), we stated:

"That the language used in § 26(c)(1) does not authorize a credit for statutorily prohibited dividends is further supported by a consideration of § 26(c)(2). By this section, a credit is allowed to corporations contractually obligated to set earnings aside for the payment of debts. That this section referred *to routine contracts dealing with ordinary debts and not to statutory obligations is obvious*—yet the words used to indicate that the section had reference only to a 'written contract executed by the corporation' are identical with those used in § 26(c)(1). *There is no reason to believe that Congress intended that a broader meaning be attached to these words as used in § 26 (c)(1) than attached to them under the necessary limitations of 26(c)(2).*" 311 U. S. 46, at 49-50. (Italics suplied).

We thus held that § 26(c)(1) is limited to contracts involving ordinary obligations to creditors and since preferred stockholders are not creditors, *Warren* v. *King,* 108 U. S. 389, 399, § 26(c)(1) does not apply here.

Petitioner contends, however, that our construction of § 26(c)(1) was erroneous but for reasons given in the *Northwest Steel* case we think it was correct and adhere to it. Our construction finds further support in § 26(c)(3) which, in order to prevent "Double credit", provides that in the event both Subdivisions (c)(1) and (c)(2) apply, "the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied." Congress having thus made the relief obtainable under (c)(1) and (c)(2) mutually exclusive has indicated that it considered the two subdivisions as interdependent. Congress therefore intended to cover the same type of contract, namely a contract with creditors, in both subsections and not to extend subdivision (c)(1) to intra-corporate contracts while subdivision (c)(2) was to cover contracts with creditors only. Moreover statements made in the course of the Congressional debate[3] refer to § 26(c) as a

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[3] See for illustration the statement by the Hon. Samuel B. Hill, 80 Cong. Rec. 6004.

whole, as providing for the relief of corporations prevented from paying dividends by contracts involving the payment of debts. No other view of the Section would be in keeping with the policy behind the undistributed profits tax. That tax was designed to reach profits held by the corporation which as a consequence could not be taxed as dividends in the hands of stockholders. An intra-corporate agreement is simply one way of keeping profits in the corporation's treasury so that the tax collector cannot reach them.[4] To hold that such an agreement entitled the corporation to tax credit would defeat the very purpose of the undistributed profits tax.[5] The rejection of petitioner's claim for tax credit was proper.

Affirmed.

Mr. Justice BURTON dissents.

Mr. Justice JACKSON took no part in the consideration or decision of this case.

[4] See Warren Telephone Co. v. Commissioner, 128 F. 2d 503, 506. Here there was nothing in the agreement that absolutely prohibited the payment of dividends. During 1937 and 1938 transferor had outstanding 1,294 shares of preferred stock of a total par value of $64,700. Those shares were all retired in 1939. Had they been redeemed in 1937 there would have been nothing in the agreement preventing the distribution of earnings. Consequently it does not clearly appear that there was any provision in the agreements absolutely prohibiting the payment of dividends. Cf. Dr. Pepper Bottling Co. v. Commissioner, 45 B. T. A. 540; Staley Manufacturing Co. v. Commissioner, 46 B. T. A. 199, 205.

[5] The Board of Tax Appeals and later the Tax Court have consistently held that § 26(c)(1) does not cover the type of agreement here involved. Thibaut D. Walker Co. v. Commissioner, 42 B. T. A. 29; Eljer Co. v. Commissioner, decided Dec. 4, 1941, 1941 P-H B. T. A. Memorandum Decisions, Par. 41,533; Budd International Corp. v. Commissioner, 45 B. T. A. 737; Bishop D. Babcock Manufacturing Co. v. Commissioner, 45 B. T. A. 776; Philadelphia Record v. Commissioner, decided January 23, 1943, 1943 P-H T. C. Memorandum Decisions, Par. 43,038.

Mr. Justice Reed, dissenting.

Accepting *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46, completely, I am unable to agree that this contract with preferred stockholders was other than a "routine contract dealing with ordinary debts." Certainly this is not an instance of a "statutory obligation," which are the words used in the *Northwest* case to describe the antithesis of the contract covered. "Routine" and "ordinary," as used in *Northwest*, do not imply to me anything more than an express contract, executed in accordance with Section 26(c)(1).

The exemption provisions of Section 26(c) make no exceptions because the debt of the corporation is owned by a stockholder. If such an exception is to be deduced from the purpose behind the words of the section, it should not be applied to such preferred stockholders as these because their interest is like that of a creditor. As I believe the statutory requirements are met, I should reverse.[1]

The Chief Justice joins in this dissent.

[1] See in accord, Lehigh Structural Steel Co. *v.* Commissioner, 127 F. 2d 67; Budd International Corp. *v.* Commissioner, 143 F. 2d 784; Philadelphia Record Co. *v.* Commissioner, 145 F. 2d 613; Rex-Hanover Mills Co. *v.* United States, 53 F. Supp. 235. See Eljer Co. *v.* Commissioner, 134 F. 2d 251, 255.